



THE SEGAL COMPANY  
120 Montgomery Street, Suite 500 San Francisco, CA 94104-4308  
T 415.263.8200 F 415.263.8290 www.segalco.com

January 12, 2007

Via EMAIL and US MAIL

Mr. Edward F. Overton  
Director/Retirement Services  
City of San Jose Police and Fire Department Retirement Plan  
1737 North First Street, Suite 580  
San Jose, CA 95112-4505

**Re: City of San Jose Police and Fire Department Medical and Dental Insurance Plan  
GASB Statements No. 43 and No. 45 Results Using Requested Assumptions**

Dear Ed:

Our original draft valuation report for the City of San Jose Police and Fire Department Medical and Dental Insurance Plan dated October 24, 2006 was presented to the Board of Retirement on November 2, 2006. After the draft report was presented to the Board, a number of questions arose regarding differences in assumptions and methodologies between our draft valuation report and the valuation report issued by GRS (actuary for the Federated System) for the Federated Medical and Dental Plan.

We met with representatives of the City, GRS, representatives of the Retirement Boards and Macias and Gini (auditors for the City and the Retirement Systems) on December 8, 2006 to discuss the differences in assumptions and methods between GRS and Segal. As a result of that meeting, we were requested by your office to recalculate the GASB 43 and 45 results with both an 8.0% discount rate and a 5.3% discount rate, using both the Entry Age Normal (EAN) and Projected Unit Credit (PUC) cost methods. In addition, we have addressed several issues in this letter that were raised in our December 8 meeting.

**➤ Rerun the GASB 43 and 45 results using both a 5.3% discount rate and an 8.0% discount rate.**

Benefits, Compensation and HR Consulting ATLANTA BOSTON CALGARY CHICAGO CLEVELAND DENVER HARTFORD HOUSTON LOS ANGELES  
MINNEAPOLIS NEW ORLEANS NEW YORK PHILADELPHIA PHOENIX PRINCETON RALEIGH SAN FRANCISCO TORONTO WASHINGTON, D.C.



**Multinational Group of Actuaries and Consultants** BARCELONA BRUSSELS DUBLIN GENEVA HAMBURG JOHANNESBURG LONDON MELBOURNE  
MEXICO CITY OSLO PARIS

Our original draft valuation report contained the results using both a 4.5% discount rate and an 8.0% discount rate. The 4.5% discount rate was predicated on the assumption that there would be no change in the Police and Fire Board's contribution policy to fund the cashflows for the medical and dental benefits payable over the next 10 years while the 8.0% discount rate was provided for illustrative purposes assuming that the liability would be funded on a full actuarial basis.

In the GRS report for the Federated Medical and Dental Plan, they provided the calculation using only the 8.25% discount rate they used for the Federated retirement benefit valuation assuming that the liability would be funded on a full actuarial basis.

At the December 8 meeting, the City requested that we provide an additional set of results assuming a 5.3% discount rate under the current 10-year cashflow funding policy. The 5.3% discount rate was calculated by weighting an assumed rate of 5% that the City believed it would be able to earn on its investment with the 8% return that the Police and Fire System would earn for contributions deposited under the current 10-year cashflow funding policy.

At the meeting, we requested the City to confirm that their 5% investment return assumption was a long term assumption because at the current time, the yields on 10-year and 30-year Treasury bonds are in the range of 4-5%. We have also confirmed, based on a review of a 2006 study prepared by the Police and Fire Board's investment consultant (that we received for another California public retirement plan client) that their prediction for return on shorter term cash investments was about 3.6% per annum over the next 20 years.

At the meeting, Macias and Gini opined that the 5.3%<sup>1</sup> discount rate requested by the City for the Police and Fire plan was within the reasonable range for such an assumption under GASB 43 and 45. We would defer to the Police and Fire Board's auditor as the final authority in the matter of selecting the ultimate discount rate.

➤ **Rerun the GASB 43 and 45 results using both the Entry Age Normal (EAN) and Projected Unit Credit (PUC) actuarial cost methods**

Our original draft valuation report contained the results using the EAN actuarial cost method, the same funding method adopted by the Police and Fire Retirement Board for budgeting contributions for retirement benefits. GRS had prepared results for the Federated Medical and Dental Plan using the PUC method even though the Federated Board uses the EAN method for funding retirement benefits.

---

<sup>1</sup> For the Federated Plan, the rate requested by the City was 5.6%.

The EAN method develops cost as a level percentage of payroll over each member's active working lifetime. The PUC method develops costs that accrue in proportion to the value of the service rendered by each member. The PUC costs generally start out lower but they will continue to increase as a percentage of each member's pay over their active working lifetime. Both methods are acceptable under GASB 43 and 45 and we believe there are merits for using a consistent actuarial funding method (i.e., EAN) for valuing the full actuarial accrued liability for retirement, medical and dental benefits. However, the choice of actuarial funding method is at the full discretion of the Retirement Board.

➤ **Healthcare trend assumption**

Our original draft valuation report used an initial healthcare trend assumption of 12% per year, grading down 1% per year down to an ultimate rate of 5%. The GRS valuation report for the Federated Medical and Dental Plan used an initial healthcare trend assumption of 12% per year, grading down 1% per year down to an ultimate rate of 4%. The 4% ultimate healthcare inflation assumption was also used by GRS as the general price inflation assumption. The initial issue was that Segal's ultimate medical trend assumption was higher than the general price inflation.

At the meeting, we explained our belief that there would continue to be increases in the utilization of medical services, etc. that would cause healthcare expenditures to outpace general price inflation. Since there would be real growth in wages, we do not believe a higher healthcare trend assumption would result in a prediction that healthcare expenditures would constitute a higher and higher percent of the U.S. economy over a very long period of time. In addition, at a recent meeting among a number of actuaries that perform GASB 43 and 45 studies in California, the general consensus was that ultimate healthcare inflation would be higher than general price inflation. The above arguments together with the observation that actual healthcare expenditures have exceeded our near term healthcare trend assumption over the last several years led us to continue to recommend to the Police and Fire Board the assumptions outlined in our draft report dated October 24, 2006.

It is our understanding your auditor is comfortable with our 5% ultimate trend rate assumption and GRS would also provide an alternative set of results assuming an ultimate healthcare trend of 4.5%.

➤ **Percentage of Medicare Eligibles**

Our draft valuation report stated that we were using an assumption that 90% of retirees reaching age 65 were eligible for Medicare. A question was raised at our December 8 meeting as to the appropriateness of the 90% assumption, given that individuals not eligible for Medicare at age 65 are required to enroll in Medicare.

After reviewing our valuation program we believe this assumption is appropriate, although the use of this assumption has no impact on the valuation results. The reason that this assumption has no impact on our valuation results is that regardless of whether a member is in Medicare, the Plan will pay the maximum subsidy for all members reaching age 65 when we take the Medicare Part B premium reimbursement into account.

➤ **Implicit Subsidy**

It is our understanding that for premium setting purposes, retirees not eligible for Medicare are pooled with active members. In general, the cost of healthcare for retirees is more expensive than for active members. For example, the true cost for a retiree may be \$500 per month and the true cost for an active member under age 65 may be \$200 per month. When they are pooled, the average cost may be \$350. The difference between the \$500 true cost for retiree coverage and the \$350 “pooled cost”, or \$150 per month, is an “implicit subsidy” that must be valued under the GASB 43 and 45 requirements. Both Segal and GRS included the costs for the “implicit subsidy” in their valuation reports.

However, GRS reduced the “implicit subsidy” based on the idea that retirees generally have fewer children covered than actives. We have reviewed our internal calculations and have concluded that any adjustment we might incorporate to reflect the lower number of children for retirees would not have a material impact (less than 1% of payroll under the 4.5% discount rate scenario where the total Annual Required Contribution is 31.3% of payroll) on our valuation results.

**Summary**

We believe that all the actuarial assumptions and methods we used in our draft valuation report are in accordance with accepted actuarial principals. At the request of your office, we have prepared additional results using a 5.3% discount rate and an 8.0% discount rate, under both the EAN and PUC actuarial cost methods.

The attached exhibit contains our original valuation results and the results using the assumptions and methods requested by the Board. All results in the table are based on the same data used for our draft valuation report as of June 30, 2006. All actuarial assumptions are identical to the assumptions used in our draft valuation report, with the exception of the discount rate and the actuarial cost method, as noted above.

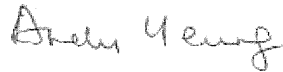
Mr. Edward F. Overton  
January 12, 2007  
Page 5

If you have any questions, please let us know.

Sincerely,



Paul Angelo, FSA, EA, MAAA  
Senior Vice President & Actuary



Andy Yeung, ASA, EA, MAAA  
Associate Actuary

Enclosure

MAM/bqb

**SUMMARY OF VALUATION RESULTS AS OF JUNE 30, 2006**

<b>ACTUARIAL COST METHOD</b>	<b>EAN*</b>	<b>EAN</b>	<b>PUC</b>	<b>EAN*</b>	<b>PUC</b>
<b>DISCOUNT RATE</b>	<b>4.50%</b>	<b>5.30%</b>	<b>5.30%</b>	<b>8.0%</b>	<b>8.0%</b>
<b>Actuarial Accrued Liability by Participant Category</b>					
Current retirees, beneficiaries and dependents	\$469,344,884	\$422,456,701	\$422,456,701	\$310,871,446	\$310,871,446
Current active members	<u>493,493,935</u>	<u>428,760,659</u>	<u>454,702,457</u>	<u>277,893,924</u>	<u>265,904,549</u>
Total	\$962,838,819	\$851,217,360	\$877,159,158	\$588,765,370	\$576,775,995
<b>Actuarial Value of Assets</b>	\$38,381,423	\$38,381,423	\$38,381,423	\$38,381,423	\$38,381,423
<b>Market Value of Assets</b>	\$40,519,000	\$40,519,000	\$40,519,000	\$40,519,000	\$40,519,000
<b>Unfunded Actuarial Accrued Liability</b>	\$924,457,396	\$812,835,937	\$838,777,735	\$550,383,947	\$538,394,572
<b>Funded Ratio</b>	4%	5%	4%	7%	7%
<b>Annual Required Contribution (ARC)</b>					
Normal cost	\$41,956,307	\$34,053,189	\$31,551,711	\$17,495,644	\$16,908,634
Amortization of the unfunded actuarial accrued liability	33,006,106	32,255,372	33,284,808	30,079,973	29,424,722
Less Employee Contributions	(8,260,094)	(8,260,094)	(8,260,094)	(8,260,094)	(8,260,094)
Adjustment for timing (payable throughout the year)	<u>1,686,654</u>	<u>1,757,177</u>	<u>1,718,168</u>	<u>1,903,025</u>	<u>1,853,334</u>
Total annual required contribution, including adjustment for timing	\$68,388,973	\$59,805,644	\$58,294,593	\$41,218,548	\$39,926,596
ARC as percent of payroll (based on projected payroll of \$218,521,000 for fiscal year 2006-2007)	31.3%	27.4%	26.7%	18.9%	18.3%

\* Results presented in draft report dated October 24, 2006.